DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

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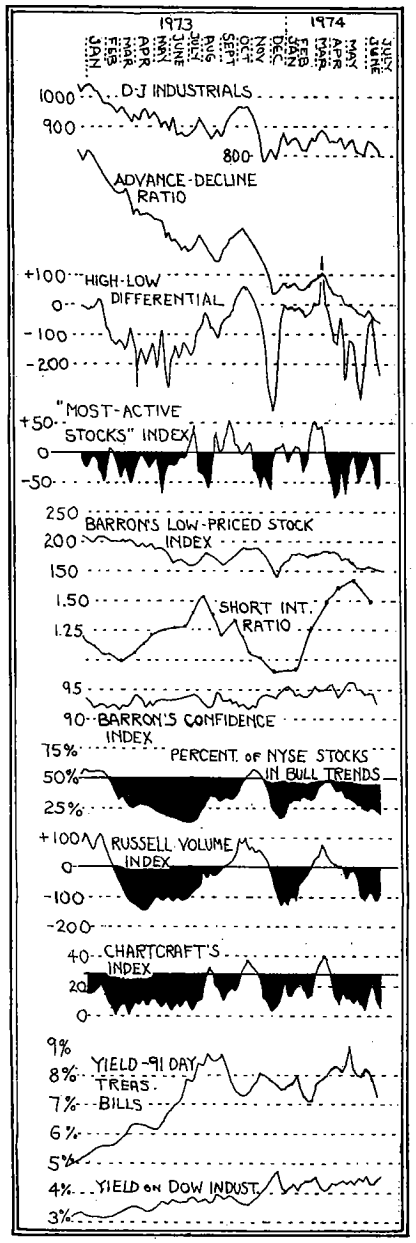
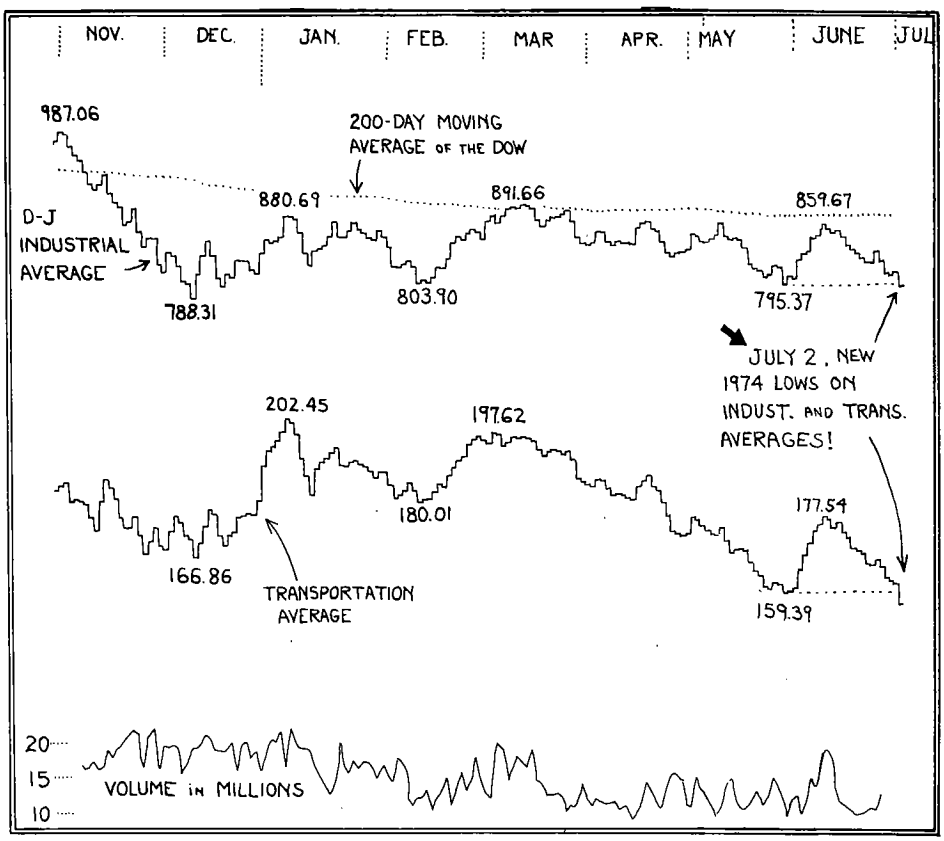
June 21, DJIA 815.39; PTI 412; A-D ratio -25.69
June 28, DJIA 802.41; PTI 392; A-D ratio -26.71



THE PICTURE: In May the US suffered a trade deficit of $775 million, second worst deficit for any month on record. Last week Eurodollar rates (suddenly nobody wants Eurodollars) rose to a record 14.25% for short-term. Not to be outdone, the British market slumped to a 15-year low, while a seat on the NYSE sold for $73,000, down 85% from the $515,000 high of 1968. At the same time it was announced that the quality of margin (now $5.2 billion) on the NYSE had deteriorated badly. Over 45% of the $5.2 billion is now held in accounts with under 40% equity. Those were the May figures, and it is doubtful whether the margin situation improved any during June.

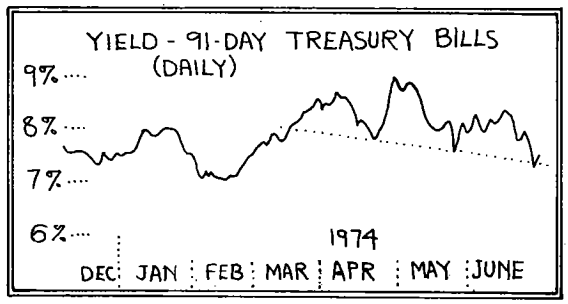
What's happening, what's gone wrong? The answer: there's a giant squeeze in world liquidity, and it is scaring the devil out of investors, large and small, from one end of the globe to the other. Last week two German banks declared bankruptcy, while it was revealed (WSJ, June 26) that an oil-drilling "tax write-off" situation has turned into what may be the biggest swindle in US history. On June 27 trading in Westinghouse was halted at 12 1/8 ("you can be short if it's Westinghouse"), and an hour later the President of the company announced that the outfit was solvent (all this while WX broke its 1962 low).

Giant Citicorp on June 24 announced to an astounded investment world that it was offering 15-year "floating notes" to be purchased in amounts as low as $5,000 (as against a $10,000 minimum for T-bills). The notes could be redeemed every six months at the face amount. Citicorp would pay a rate of interest equal to the average yield for the last six months on T-bills, plus 1%. This gives us some idea of the battle which is now on for liquidity, and it shows the desperation which the money managers must feel as they do battle for cash against all comers. The US Government, sensing the implications of the Citicorp venture (which was boosted from $250 million to $850 million within a few days!), indicated that it might halt the offering. One reason for the Government's fear — AAA rated Citicorp was gunning for everyone else's deposits, and with the new floating note concept, they might very well get them!



I am including (page 2) my "chart of the week," which shows the "head-and-shoulders" top in US Treasury 91-day yields. The chart reveals the tremendous strength in T-bills (and of course strength in the bills' price means a decline in their yield,

which is now down to 7.4%). At the same time it should be noted that the stocks of most bank shares have virtually collapsed, with many bank equities now yielding up to 10%. Put it all together, and what do we come up with? I come up with investor fear, and a headlong rush to safety. Bank shares at 10% yields mean that investors are scared of the banks. Eurodollars at 14% mean that investors have become fearful of Eurodollars. New loans on the D-J 40-Bond Average indicate a route out of bonds, and what the stock market is saying is clear enough. All of this is bearish, very bearish, but it is telling us a most definite story.



It is telling us that we are witnessing a mass flight by investors toward the storm cellars. The world liquidity crisis, the fall of a number of banks, the Eurodollar rates, the current weakening of foreign currencies against the dollar, the crescendo of inflation, all of these are pointing investors towards three main avenues of safety: (1) T-bills, the safest short-term debt instruments in the Western World, (2) gold coins, representing real money, and (3) gold stocks, representing companies that produce real money.

Despite all this, business seems to remain optimistic. All the projections and forecasts I read call for new highs in capital spending, at least that's what Time, Newsweek, Business Week, and US News tell me. But I am afraid that hopes and "the best laid plans" are about to clash with the reality of the marketplace. When capital spending rises, money must be raised, big money. And when corporations need money, they turn to the equity markets, the bond markets or the banks. The equity markets have been pulverized, there is some question as to whether the bond market should still be termed a "market," and the banks have all they can handle just holding up the massive loans they now have outstanding.

So that is the situation. The wells of credit (and confidence) are running dry. If the credit markets dry up, then we are heading for a dramatic reversal, including slashed corporate spending programs, cancelled contracts, inventory liquidation, and revised forecasts by the score. It's as simple and brutal as that.

Now a slowdown when everyone and his brother is flush with cash is unpleasant, but it is nothing to worry about. You don't switch from sirloin to hot dogs when you have a fat bank account. But when the word "illiquidity" is all over the financial pages of your newspaper, then a slowdown in business becomes a frightening affair. The fact is that the stock market has been issuing its warnings for months (actually, for years), and it is telling us that the gravy-train is about to run off the tracks. New lows on the D-J Utility and D-J 40-Bond Averages have always been bearish for Wall Street. For months now both of those money-oriented indicators have been crashing (telling those of us who would listen a most important story).

With it all, the focus of attention continues to center on the D-J Industrial Average. The Dow remains the bellwether indicator of American stocks, the core of market psychology. In the 78 years of its history, the Dow has captured the imagination of the nation in the same way that the cowboy has, or apple pie, or Paul Revere.

Call it incredible, but the man on the street won't really believe it's a "major bear market" until the Dow starts unravelling on the downside. True, unweighted averages of NYSE stocks have lost two-thirds of their value since 1968. Professor Davis's "median NYSE share price" (see Letter 599) fell to $15\frac{1}{2}$ last week, lowest level in modern history. But it's the Dow that the public watches, it's that Dow that is "hooked in" to the public's emotions.

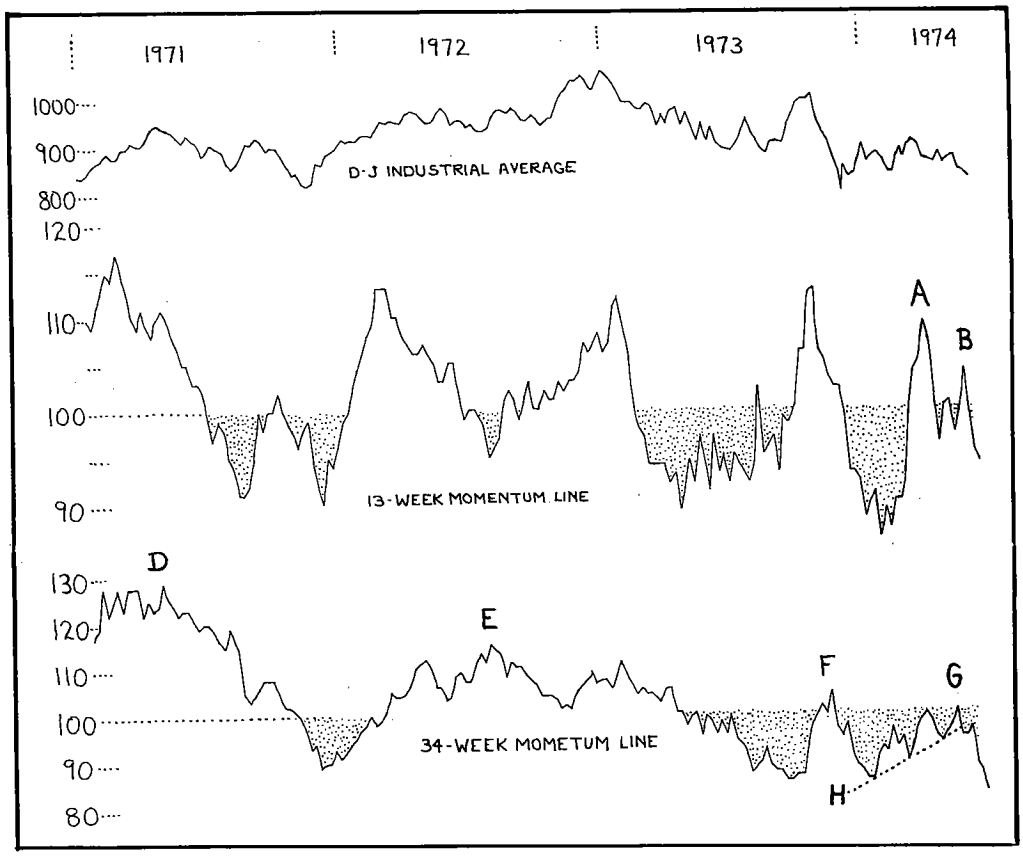
All of which has led to an incredible phenomenon. In the face of an utter collapse in US equity markets, the Dow (by holding above or near the 800 level) has kept alive the deception that "a new bull market is just around the corner." This deception, which has lasted over six years, has undoubtedly been one of the most costly and painful episodes in the annals of Wall Street. It is a deception which continues as of this writing.

The last week in June faded out leaving us with a rather dismal set of statistics. The week's plurality of new lows over new highs was (minus) 624, second worst showing of 1974. On the last trading day of June the A-D ratio, the PTI, the cumulative most-active stock index, and the D-J 40-Bond Average all hit new lows for the year. So much for June.

July 1 (Monday) began with another of those bear market rallies in which the Dow goes up while the Transports stand still and the advance-decline ratio actually declines. So far, this kind of exotic upside action seems to have been capable of stirring up faint sparks of bullishness. Perhaps we will get a flare-up of optimism again. But the big picture is that we're still in a primary bear market. I trust that my subscribers comprehend the full meaning of that statement.

MOMENTUM: According to Dow's Theory the Averages discount everything. Here is how Robert Rhea, the great Dow Theorist of the 1930's put it, "The fluctuation of the daily closing prices of the D-J Rail (now Transport) and Industrial Averages afford a composite index of all the hopes, disappointments, and knowledge of everyone who knows anything of financial matters, and for

that reason the effects of coming events (excluding acts of God) are always properly anticipated in their movements. The Averages quickly appraise such calamities as fires and earthquakes."



I firmly believe this basic tenet of Dow's Theory. People have been writing to me for years saying that I should "adjust" the D-J Industrial Average for the effects of inflation, the rise of the gold price, the effects of institutional influence, etc. My answer is that the Averages are automatically adjusting every minute, that the Exchange is open. As far as inflation and the gold price is concerned, the price/earning ratios take care of this. At times of drastic deflation, the Dow may sell as low as seven times earnings as it did in 1949. In times of great optimism and inflationary expectations such as 1961 the Dow has sold at 24 times earnings. In other words, the Dow adjusts constantly for all known data and it reflects all expectations.

Such is the meaning of the movements of the Dow. I have spent the better part of my adult life studying these movements and their meaning. One of the great aids in working with the movements of stocks or an average is the momentum studies. Price movements in the market tend to run along recognizable "growth" or "decline" rates, and these rates can be expressed in terms of ratios.

For my studies, I use a 13 week and a 34 week period. I note what the Dow does as compared with its price of 13 weeks ago, and compared with its price 34 weeks ago (I have tested many time spans and happen to like these two). When these ratios are plotted, we have what I term momentum lines; it's as simple as that.

The momentum lines can show you two things: (1) If the momentum line is above 100 it means that the stock is above its price of 13 weeks ago (or 34 weeks ago if I am referring to the long-term momentum line). (2) If the momentum line is rising on a trendline basis, it means that the rise is taking place at a certain rate. For instance, a rising momentum trendline may reflect a growth rate of 10% which means (as long as the price holds above the trendline) that the current week's price is consistently 10% above its price of 13 weeks ago.

All of the above may sound very simple, but it can also prove to be very valuable. Refer to the accompanying chart of the Dow, covering weekly momentum (both 13 week and 34 week ratios) for the past four years. Remember, the Dow has been fluctuating between roughly 800 and 1000 during this entire period. (Note: all momentum movements under 100 have been shaded with dots).

First let's examine the short term or 13 week line. During the frustrating 1971 to 1973 period, the 13 week momentum rose above 110 on four occasions, 1971, early-1972, late-1972 and 1973. Following each of these pushes the momentum dropped back to the 90 area. Each of these momentum moves forecast corresponding movements in the Dow (up or down arrows on chart).

Then we arrive at 1974. Here we saw some "new" and unusual action in momentum. During March the momentum line pushed up to a sub-standard 108 top (A on chart). It dropped back to 90, then rose to an even less impressive 106 peak (B on chart). Following B the momentum broke badly, tracing out a downward zig-zag. This whole performance constituted a very weak showing, weaker than anything seen since 1971. I felt it spelled trouble for the Dow, which had (in 1974) displayed less upward momentum than at any time in recent years.

Next, study the long term or 34 week momentum line. Here we see a different picture, a picture of descending momentum since the 1971 high of 129 (D on chart). Following a decline to 89, momentum turned up in late-1971 but got no higher than 115 in 1972 (E on chart). In 1973 momentum turned negative (in April), then pushed up to a very sub-standard 104 (F on chart) in October of that year.

The year 1974 has produced no plus figures on the 34 week momentum line, merely a 100 reading (G on chart) in April. Note the rising trendline which is marked H. This trendline (which is totally within negative territory) was reversed to the downside in April of this year. The break took the 34 week momentum to last week's low of 82, the lowest level in years.

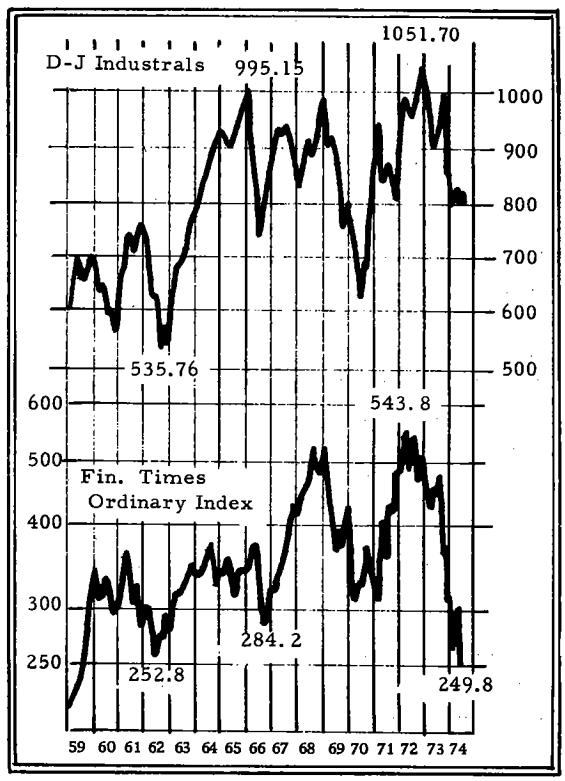
The November, 1971, low for the 13 week momentum line occurred at 90. The March, 1973, low for 13 week momentum came at 89. In January, 1974, the 13 week momentum line slid to a low of 86, the lowest level in four years. As a guess, I would say that we are now heading for a new low on the 13 week momentum series, perhaps a figure in the low 80's or even in the high 70's.

The 34 week momentum line has held under the 100 level (within the shaded portion) ever since April, 1973, or for a period of over a year. If subscribers will draw a trendline through points D and F on the 34 week momentum line, they will see that the Dow has been (subtly) losing strength ever since 1971. This is a long-term bearish situation, and I believe it will result to ultimate collapse as the strength still residing in the Dow finally washes out on the downside.

AS BRITAIN GOES .....I have stated in many previous reports that there is an apparent close correlation between markets in the US and in Britain. The reason, aside from the close economic ties of the two nations, appears to be the intimate social ties as well. It seems to work like this: no matter what ding-bat or hair-brained ideas our British cousins come up with, within a matter of months (occasionally years) the US can be counted on to try them too.

So far, British socialism has served to reduce Britain to the status of a chronic bankrupt, and the once proud pound sterling has been relegated to a currency which no one really wants anymore (unless accompanied by gold guarantees). So for whatever reason, there does seem to be a fairly strong connection between the movements of Dow Industrials and the Financial Time Index of Ordinary shares.

I have drawn the 16-year chart, showing the DJIA (arithmetic scale) and the Financial Times Index (ratio scale). The different scales were used in order to coordinate the movements in the two markets more closely. As a rule, the British market will top out first and the US market will bottom out first. This could be because the US market is the stronger. In other words, the US market will sustain a primary move even after the British market tops out, and the US market will turn up even while the British market remains in the doldrums.



It is the most recent history which I want to discuss. On May 19, 1972, the Fin. Times Index hit an all-time high of 543.8. The Dow continued to climb, even while the British market declined, and eight months after the British peak the Dow recorded its own all-time high of 1051.70.

Meanwhile the British stock market was in the throes of a massive collapse. On June 21, 1974, the Fin. Times Index broke below its 1962 low of 252.8, thereby wiping out better than 50% of the value of the Index. At the same time, the Dow broke temporarily below the 800 level. But so far the Dow has stubbornly resisted following the lead of Britain. A comparable Dow decline would take the Average down 54% (the amount of the British decline) to about 480 — or well below the 1962 low of 535.76.

Obviously, history does not have to repeat or certainly it does not have to repeat in the identical way. But I thought the above study was interesting enough to include here.

BUILT-IN DISASTER: In Letter 597 I presented a section on the wild turnover of demand deposits at the New York banks. I called that section "White Heat." Few people realize that increased spending and inflation (and ultimate collapse) are very literally built into the US economy.

For instance, there is a whole area of government spending which we term the "uncontrollables." According to the David L. Babson Co. (1 Boston Pl., Boston, MA 02108) these uncontrollable expenses have risen from $94 billion or 59% of the total 1967 Federal budget — to $197 billion or 72% of the 1974 budget! The uncontrollable expenses include such items as Social Security, Medicare and Medicaid, Veteran's benefits, subsidized housing, Federal Retirement Insurance, etc.

As if this is not ominous enough, it should be realized that the number of people qualifying for these various benefits is mushrooming. The implications are obvious. The proliferating built-in Government expenses are eating the nation up alive (fiscally speaking).

One area which is, of course, a direct recipient of the exploding government spending programs is the Federal budget. Here, the story is one of continuous and mounting deficits. During 1946-51 total Federal budget deficits added up to $3.9 billion or an average of $.8 billion a year. During the 1961-65 period the deficit total added up to $22.8 billion or an average of $4.6 billion per year. The latest: for the 1971-75 years the total budget deficit will be $74.7 billion or an average of $14.9 billion per year.

Remember, the Federal deficits plus all the other debt in the nation is now being financed and re-financed at the highest interest rates seen since the Civil War. These compounded expenses are resulting in massive inflation, sky-rocketing additional debt and horrendous illiquidity throughout the nation.

The solution will be (1) depression and liquidation of debt, or (2) repudiation of debt and a new economic, and perhaps political, system, or (3) a huge rise in the price of gold, and a great expansion of the world liquidity and reserves based on the new price of gold.

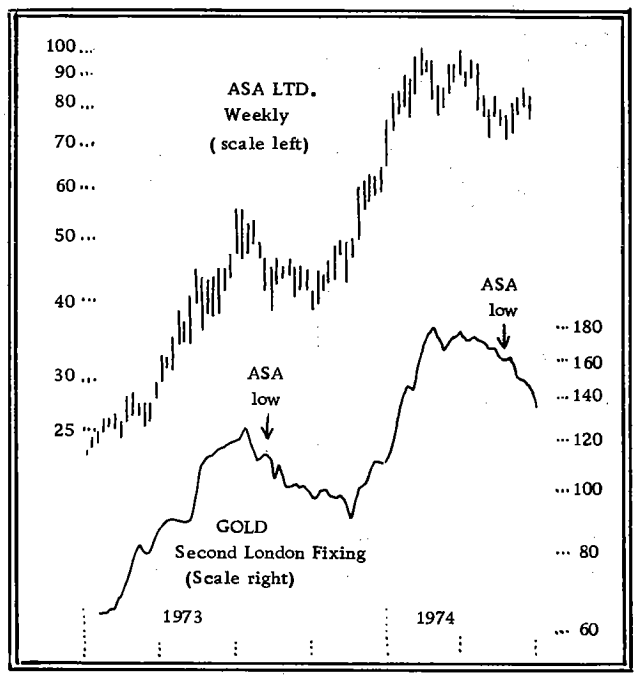
Sometimes I look over the whole fiscal mess, and I ask myself, "How did it happen; who let it happen?" And the answer is that everyone let it happen. A student of government once observed, "the people are lazy, but the politicians are energetic." I don't know whether that's really fair, but it is true that democracy can only survive with an informed electorate. Democracy is based on the thesis that the citizens know what is best for them, and that they can elect leaders to carry out their (the people's) wishes.

But the problem is that people believe what they want to believe, and politicians will tell people anything they have to tell them in order to get elected. Did you ever hear of a politician winning on a "tighten your belt" platform? It's never happened. Politicians win by telling the people what they're going to give them, not what it's going to cost them.

So, we're finally coming to the end of the tunnel (as I've been warning that we would), the land of "two plus two equals four." The truth is that inflation is so bad now that people are beginning to distrust their money, and nations are beginning to distrust each other's money. Currently, we are at the place where long-term money is almost impossible to obtain. Nobody trusts the bond market anymore. Everyone is turning to the short-term market to finance their long-term requirements. And that's dynamite, pure dynamite!

A few weeks ago a story emerged via the "Money Manager" (a very respected weekly). It was stated that a "special relationship" accord between the US (signed by Kissinger) and Prince Fahd al Saud (cousin of Faisal) provided that Saudi Arabia would invest at least $10 billion a year in the US by purchasing "special issue" US Government securities. The US, the article stated, would back the securities with its $11.5 billion gold store! The US departments of State and Treasury refused to confirm or deny this astounding rumored agreement. It's come to that!

GOLD: With record interest rates world-wide, the correction in gold bullion continues. But I feel that we are nearing the bottom, and I also believe that the NYSE listed gold shares have already discounted the final low for gold bullion. To illustrate, I include a ratio chart of ASA, perhaps the greatest single bellwether of the entire gold picture.



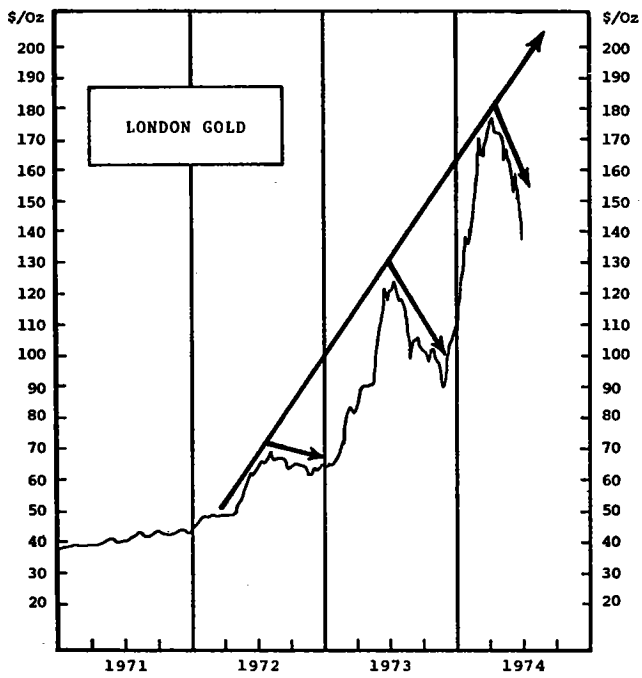
Note that in mid-1973 ASA hit a low of 38, then held that low despite the fact the bullion drifted lower for a number of weeks. In October ASA began a strong upward movement which took the stock to 99.5 before the move ended. I feel that we are seeing the same kind of action today among the listed golds and among other selected gold leaders. Remember, although speculation in gold during late 1973 was greater than during late-1972 and early-1973, there are also more sophisticated gold buyers around today. This means that there will be more investors willing to "jump the gun" and buy the shares prior to the next move in bullion.

I believe that the buying in gold shares now is of investment quality, since most of the amateur public has been shaken out of the gold picture, and it requires sophisticated thinking and hard nerves to pick up the shares as bullion sinks to new reaction lows. Yet, ASA, for instance, is a good distance off its 1974 reaction low of about 70.5, and I do not think that low will be violated. When the next gold rise begins, it should be violent, more violent than the late-1973 affair.

Next, I want to include two items (page 6) from Larry Heim's new Heim Investment Letter (812 SW Wash. St., Ste. 600, Portland, OR 97205). The first is a rundown on the latest whopping S. African gold dividends. The second is an unusual chart of gold

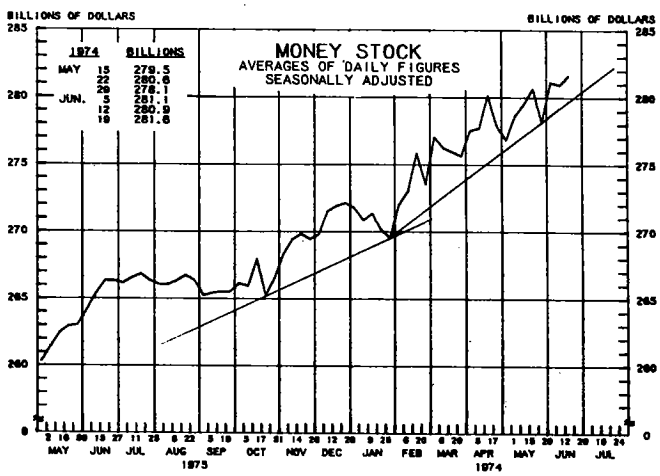
illustrating the three corrections since 1971. Note that each correction has been steeper than the last — and faster. When the current correction is spent, the upside reversal should be violent.

Company Name	Dividend Paid Aug. 1973	Dividend Paid Feb. 1974	Dividend Payable Aug. 1974
Blyvooruitzicht	$0.24	$0.43	$0.69
Doornfontein	0.37	0.43	0.81
Durban	0.30	0.62	0.75
East Driefontein	NIL	0.12	0.24
East Rand Prop.	0.14	0.81	0.94
Elsburg	NIL	0.03	0.14
Hartebeestfontein	0.81	0.62	1.37
Kloof	0.37	0.36	0.62
Libanon	0.37	0.43	0.81
Vaal Reefs	0.62	0.81	1.25
West Driefontein	1.50	1.76	3.26
Western Areas	0.10	0.32	0.22
Western Deep	0.52	1.00	0.87

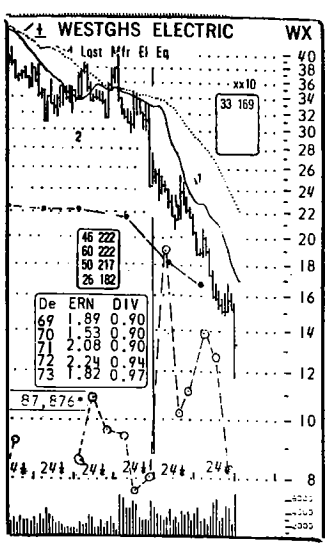


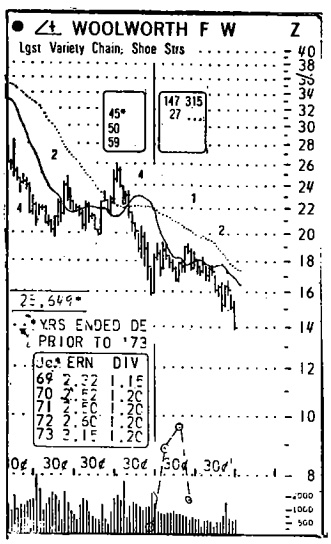
DESPITE the usual optimistic official prediction of "declining inflation" towards the end of the year (it's always six months away!), average hourly wages of non-farm workers in May alone rose a fantastic 19.1% — on an annual rate. The Railway and Airline clerks now want a 35% boost over the next two years; Anaconda workers are asking upwards of 35%. Meanwhile, despite Mr. Burn's inflation warnings, the latest St. Louis Fed chart shows the money supply (see chart) at new record highs. I repeat, wait and see the monetary inflation when the economy really turns down.

Peter Beter: I'm getting dozens of letters about this former legal counsel for the Amer. Gold Assoc. and the Export-Import Bank. Beter claims that there is no more gold in Fort Knox; it has all been shipped to Holland to be bought back later at super-high prices. National Tattler (July 7, 1974) tried to check this fantastic story, but it got nowhere. The Tattler called Fort Knox, the Fed, the Treasury, and incredibly got nowhere as the buck was passed. The Tattler's conclusion, "No one actually has seen the gold in a long, long time," and "Few bureaucrats actually know what's going on within the limits of the American Government." Subscribers want to know what I think of this almost unbelievable story. I tell myself it's preposterous, but after Watergate and Patty Hearst, who am I to say that anything's impossible?



LA DOLCE VITA: Below is a tidbit from our Italian friends over the sea. My only comment is this — I take it back, I take back everything I said about the US Postal Service, the US Service is definitely not the worst in the world; it's the second worst.





SMASH: Stocks in the Dow generally go down "gently." They are all blue-chip companies, and they tend to be distributed with care. But primary bear markets are no respectors of feelings. Woolworth (which paid fat dividends all during the Great Depression) has plunged to a 15 year low. And Westinghouse has been acting like an unwanted "new issue," dropping from 40 to under 12 in a period of months. Save these charts for your grandchildren ("What was it like back in 1974, when they used dollars for money?). Above charts courtesy of Quote Digest, PO Box 213, Wichita, KS 67201.

LATE NOTE: July 2 after the close: Transports at new 1974 low, with the crucial Industrial point the 788.31 low of December 5, 1973. We're close, ominously close.

MAIL FURORE GROWS

From Reuters

MILAN—Italian postal authorities offered 400 tons of undelivered mail to a pulp mill at a price of $14.50 a ton, the mill owner said Friday.

Fiorenzo Novali said the offer was made by the Milan Postal Authority last January to his mill in Bergamo where police are now sifting through tons of undelivered mail.

The report added fuel to a growing scandal over the country's chaotic postal services.

Among the mail found at the Bergamo mill were registered and express letters, postal orders, pension books and circulars, according to press reports.

Novali said he became suspicious that he was receiving fresh mail when he found that some of his employes were taking banknotes and other valuable items from mail delivered for pulping.